

ARM Loans - Facts vs. Myth

The adjustable-rate mortgage loan is not evil, as some in the media portray. It's just frequently misused. Using an ARM loan under the right circumstances can save you money in interest. Using it in the wrong manner can lead to all sorts of financial problems, including foreclosure.

In this fact sheet, you'll learn how the adjustable-rate mortgage loan works -- and how to use them wisely.

The Adjustable-Rate Mortgage, Defined

As its name suggests, the adjustable-rate mortgage loan (ARM) has an interest rate that adjusts on a predetermined basis. This can cause the monthly payments to go up or down, depending on the prevailing rate at the time of adjustment. This is different from a fixed-rate mortgage, which carries the same rate for the entire life of the loan.

Common Types of ARM Loans

Most of the ARM loans in use today are actually hybrid loans. They are called this because they start off with a fixed rate for a certain period of time, after which the rate starts adjusting.

These loans are usually labeled with two numbers. The first number indicates the initial fixed-rate period (in years), and the second number tells you how often the interest rate and payment will adjust.

For example:

- **3/1 ARM** -- This adjustable-rate mortgage starts out with a fixed rate for the first **three** years. After that, it will begin to adjust (or "reset") every year.
- **5/1 ARM** -- This loan has a fixed rate for the first **five** years, and then adjusts every year after that.
- **7/1 ARM** -- Yep, you guessed it. This one holds a fixed rate for seven years, after which the rate will adjust once per year.

ARM Loan Terminology

If you're planning to use an ARM loan to pay for a house (or even considering it), you need to become familiar with various terms. Understanding this terminology is the only way to

compare one loan to another, and to choose the right loan for your particular needs. Here are some of the terms you should understand:

Index -- The interest rate on your adjustable-rate mortgage will be the sum of two parts: the index and the margin (see below). You can think of the index as the "going rate" at which banks borrow money from other banks. Your ARM loan will be tied to one or more of these index rates. So when the indexes rise or fall, they determine whether your rate will adjust upward or downward.

Margin -- This is basically extra interest charged by the lender. The margin refers to any percentage points the lender adds to the index rate to determine the ARM loan's rate. This is simply a way for the lender to make money. Many mortgage lenders base the margin on your credit score. They'll assign a lower margin for borrowers with excellent credit, and a higher margin to those with bad credit scores.

Fully Indexed Rate -- This is the sum of the index and the margin, both of which are defined above. If your index is 4.5% and the lender's margin is 3%, then your fully indexed rate will be 7.5%. This is the total amount of interest you will pay.

Rate Cap -- Also referred to as an interest rate cap, this feature limits the amount your interest rate can increase. There are two different types of rate caps: periodic and lifetime. As you might imagine, the periodic adjustment cap limits how much your rate can rise from one adjustment period to the next. The lifetime cap limits the increases over the entire life of the loan.

Payment Cap -- This limits how much your monthly payment can change from one adjustment period to the next. For example, if your adjustable-rate mortgage had a payment cap of 8%, your monthly payment could not increase by more than 8% over your *previous* payment amount.

To learn more about ARM loan terminology, we strongly suggest you read the Federal Reserve's brochure on adjustable-rate mortgages. It's a PDF document, and you can find it here: <http://www.federalreserve.gov/Pubs/arms/armsbrochure.pdf>

Pros and Cons of the ARM Loan

Based on everything we have covered so far, you can probably figure out the advantages and disadvantages of the adjustable-rate mortgage. Here they are in a nutshell:

- **Pros** -- You generally start off with a lower interest rate than you might get with a fixed-rate mortgage. If interest rates hold steady or decrease during the time you have the loan, you could save money.

- **Cons** -- ARM loans become unpredictable once they reach the adjustment period, because you never know *how* they're going to adjust. There's always a risk of rate increases during each adjustment. This will obviously increase the size of your monthly payment.

Scenarios Where They Make Sense

In certain situations, the adjustable-rate mortgage can save you money. If you're only planning to stay in a home for a few years, you might be able to secure a lower interest rate by using an ARM loan (as opposed to a fixed-rate mortgage).

Let's say I plan to stay in a house for three years, because of a military tour of duty. After that period, I'll be transferring to another location. In this scenario, I could use either a 3/1 ARM or a 5/1 ARM to secure a lower rate. If I move and sell the house within three years, I'll still be in the initial fixed-rate period. So the rate would not have adjusted yet. In other words, I would only keep this mortgage for the fixed period, and then sell the house before it started to adjust.

Warning: This strategy depends on your ability to sell the house. If you cannot sell it for some reason, then you would face the uncertainty of the adjustment period. The same goes for refinancing. A lot of people use the ARM loan with the goal of refinancing before the first adjustment period. But if you're unable to refinance (perhaps because you've lost equity), then you are once more stuck with your adjustable-rate mortgage. A lot of people experienced this exact scenario during the housing crash of 2008 - 2010.

Scenarios Where They DON'T Make Sense

This fact sheet was written with first-time home buyers in mind. So here is our advice for that particular audience. If you are planning to stay in the home for many years, you are better off with a fixed-rate mortgage loan. You may have to pay a higher interest rate during the first few years, when compared to an ARM loan. But the rate will never change. Thus, your mortgage payment will stay the same for the entire life of the loan.

If you use an adjustable-rate mortgage loan for a long-term stay, you will eventually be forced into making a decision. You will have to refinance into a fixed mortgage (if possible), or you'll simply have to live with an interest rate that adjusts periodically. And more often than not, they adjust *upward* -- not downward.

Where to Learn More

This document was created to give you a solid overview of the adjustable-rate mortgage loan. If you decide to use this financing method, you will need to continue your research beyond this fact sheet. Here is some recommended reading to get you started:

http://www.federalreserve.gov/pubs/arms/arms_english.htm

<http://www.hud.gov/offices/hsg/sfh/ins/203armt.cfm>

http://www.pueblo.gsa.gov/cic_text/housing/handbook/handbook.pdf

* You can also visit the Home Buying Institute at the address below, and do a search for "adjustable rate mortgage." You'll find plenty of additional information on this subject.

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